BILL # SB 1463 **TITLE:** sales tax; contracting

SPONSOR: Martin **STATUS:** As Introduced

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FISCAL ANALYSIS

Description

The bill transfers the taxable activity of the prime contracting classification to the retail classification of the Transaction Privilege Tax (TPT) and reduces the distribution base of the amended retail classification from 40% to 36%. The bill becomes effective January 1, 2008; however, contracts entered into prior to this date are exempt from the provisions of the bill.

Estimated Impact

The impact of the bill can not be determined with certainty. There are 2 factors that could significantly affect the impact of the bill: 1) the cost of materials as a percentage of the total cost of current contracts, and 2) the level of contractor noncompliance under the current tax structure. Neither factor can be determined with certainty.

Currently 65% of the value of a contract is subject to the tax. Based on Arizona contracting data, however, this analysis assumes that materials represent about 37% of the total value of contracting work done. Shifting the tax base from contracts to materials, therefore, could substantially reduce the tax base. At the 37% materials rate, and without considering any compliance issues, the bill could result in a General Fund revenue loss of up to $(387.2) million once the bill is fully implemented after FY 2009. There are several alternative estimates of the materials percentage, which range from 41% in a 1999 consultant's report to as high as a construction industry estimate of 60%.

There may be a significant level of noncompliance under the existing tax structure. Based on data in the 1999 consultant's study by Arthur Andersen, shifting the tax base to materials could increase compliance by as much as 72%. Assuming a 72% compliance increase and a 37% rate for materials costs, the bill would result in a General Fund loss of $(53.8) million.

Different materials rates or compliance factors could significantly alter this estimate. For example, using the 41% materials rate assumption in the 1999 study would result in a net General Fund gain of $39.3 million.

The Arizona Department of Revenue (DOR) estimates that, once the bill is fully implemented, it would result in a General Fund revenue loss of between $(260.8) million and $(531.8) million. The exact magnitude of the decrease would depend on growth in the retail and construction industries as well as the bill's impact on compliance, which DOR estimates could increase by up to 20%.

Analysis

Prime contracting comprises the business of construction, alteration, or demolition of any building, road, railroad, or other structure or project. Under current statute, the tax base for the prime contracting classification is 65% of the contract. The 65% figure is intended to represent the cost of materials associated with a contract. The remaining 35% is deducted as the cost of labor. The bill would eliminate the prime contracting classification and transfer the taxable activity to the retail classification. The actual cost of materials used in a contract, therefore, would be subject to the TPT under the bill.

According to the U.S. Census Bureau's 2002 Economic Census, the Arizona construction industry spent about $7.31 billion on materials in that year, while the total value of all construction work in the state was $19.93 billion. Actual materials costs, therefore, comprised about 37% of the total. This would represent a (43.5)% reduction from the current statutory rate of 65%. DOR has also used the 37% figure to generate their estimates, while the 1999 Arthur Andersen study, which employed a similar methodology, estimated that materials accounted for 41% of total contracting. Representatives from the construction industry, however, have indicated that, based on anecdotal evidence, materials are about 60% of the total value of a contract.

The bill would become effective January 1, 2008, and would therefore impact FY 2008 revenues. Contracts entered into prior to January 1, 2008, however, are exempt from the provisions of the bill. As a result, the bill would largely be implemented in FY 2009. There would still be some contracts exempted from the bill in that year, but for purposes of the analysis, full implementation is assumed in FY 2009 so as to provide a better measure of the on-going annual impact of the bill.

Under existing law, total TPT revenues deposited into the General Fund from prime contracting and retail are estimated to be $3.24 billion in FY 2009. Along with changing the retail distribution base to 36%, at the 37% materials rate the bill would decrease FY 2009 contracting and retail General Fund collections to $2.85 billion, a reduction of $(387.2) million.

The revenue loss estimated above may be offset to the extent that taxing materials results in greater contractor compliance. In addition to willful non-compliance, the complexity of the current system may make it difficult for contractors to determine the tax owed. Assessing a direct tax on materials would likely increase compliance and result in increased collections. The impact to the state from greater compliance is difficult to predict. The 1999 study by Arthur Andersen estimated that the actual value of contracting work in Arizona was $22.7 billion, but that taxes were only being paid on $13.2 billion of the total. *(See attached fiscal note for additional explanation of the Arthur Andersen study.)* Taxing materials, therefore, could increase compliance by up to 72%. Assuming this greater level of compliance, the bill would result in a $(53.8) million General Fund revenue loss.

The bill would result in a positive impact if the 41% materials rate used in the Arthur Andersen study is assumed. Under that assumption, with a 72% compliance increase, the bill would result in a net General Fund gain of $39.3 million. As a point of comparison, in its study Arthur Andersen estimated an increase in net collections of $50 million (of which $32.8 million would be deposited into the General Fund) in 1999.

Local Government Impact

Sales tax revenues are shared with local governments and any change at the state level impacts localities. Transferring taxable activity of the contracting classification to retail could either reduce FY 2009 city and county revenues by up to $(79.4) million, or increase those collections by $52.2 million. The magnitude of the impact at the local level is different than at the state level due to the interaction of the provision reducing the distribution base of the retail classification from 40% to 36%.

Besides the tax at the state level, the cities and counties assess their own individual sales tax. There could be an additional corresponding revenue gain or loss from these local taxes as well.

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